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# THE NEW MANDATE OWNERS: PASSIVE ASSET MANAGERS AND THE DECOUPLING OF CORPORATE OWNERSHIP



BY CARMEL SHENKAR, EELKE M. HEEMSKERK & JAN FICHTNER <sup>1</sup>



## I. INTRODUCTION: THE NEW CONCENTRATION IN CORPORATE OWNERSHIP

A fundamental change is underway in stock market investing. In the past, individuals and large institutions mostly invested in actively managed mutual funds, such as Fidelity, in which fund managers pick stocks with the aim of beating the market. But since the financial crisis of 2008, investors have shifted to passively managed funds which replicate established stock indices (the S&P 500, for example). The magnitude of the change is astounding: from 2007 to 2016, actively managed funds have recorded outflows of roughly US\$1,200 billion, while index funds registered inflows of over US\$1,400 billion. In the first quarter of 2017, index funds brought in more than US\$200 billion – the highest quarterly value on record. Some observers have called it the “democratization of investing,” as it significantly reduced investor expenses. Others are more critical and worry about implications of index investing that may undermine the price setting mechanism in equity markets.

In contrast to the fragmented and sizeable group of actively managed mutual funds, the fast-growing index fund sector is highly concentrated. It is dominated by just three giant U.S. asset managers: BlackRock, Vanguard and State Street – what we call the “Big Three.” Together they stand for a stunning 71 percent of the entire Exchange Traded Fund (ETF) market and manage over 90 percent of all Assets under Management (“AuM”) in passive equity funds. As a consequence of this leading role in the market for passive investment, the Big Three have become dominant shareholders. Seen together, the Big Three are the largest single shareholder in almost 90 percent of all S&P 500 firms, including Apple, Microsoft, ExxonMobil, General Electric and Coca-Cola.<sup>2</sup> Such concentration of corporate ownership is remarkable and may not have been seen since the days of the Gilded Age.

The findings of high levels of concentration in the passive index fund industry have led several highly respected scholars and practitioners – some of whom have provided contributions for this special issue – to raise concerns about possible anticompetitive effects of common ownership through the Big Three. These authors argue that common ownership may have detrimental effects on consumer price levels, and therefore they propose policy measures and regulatory tools to address this development.<sup>3</sup>

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<sup>2</sup> Fichtner, Heemskerk & Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 17 *Business and Politics*, 1 (2017). doi: 10.1017/bap.2017.6

<sup>3</sup> E.g. Azar, Schmalz & Tecu, *Anti-Competitive Effects of Common Ownership*, Ross School of Business Working Papers 1235. <http://dx.doi.org/10.2139/ssrn.2427345>.

BlackRock has recently responded to these concerns.<sup>4</sup> Among others, they argue that the common ownership studies are based on the misleading assumption that asset managers such as BlackRock own the shares held by their funds. They point out that the shares are acquired by multiple separate investment funds; BlackRock itself, for instance, has more than 100 index funds and over 800 Exchange Traded Funds. Ownership therefore does not reside at the level of BlackRock as a group, they argue, but rather at the level of individual funds. Allegedly, if the shares are not *owned* by the same legal person, the person cannot influence the policies and actions of rival companies. The common ownership studies are flawed, so they argue, because they rely on data which does not indicate *ownership*, as it relies on “threshold reporting.” According to BlackRock, this is a mere statutory requirement which does not represent a record of the true economic owner of the shares. In fact, they further imply that not even the funds are the true “owners” of the shares, but rather the clients that ultimately invest in their funds.

In what follows we propose an updated view of ownership in equity markets, and argue that asset managers such as the Big Three can in fact be seen as the relevant owners from the perspective of corporate control. We adopt a contractual approach to the corporate share and suggest that the ability to exercise *de facto* power over the voting or disposition of equity securities is a constituent element of what we call “mandate ownership.” This is precisely the type of ownership passive asset managers hold. We further argue that aggregated mandate ownership positions hold the critical element of shareholding most relevant to corporate control. We therefore submit that “threshold reporting” is not a mere statutory requirement; but rather part of a comprehensive regulatory scheme that goes beyond disclosure and exposes where power over corporations actually resides. As such, this information is relevant in light of the concerns regarding the potential anticompetitive effects of common ownership.

We proceed as follows. First, we present the contractual approach to corporate shares and explain the *asset management decoupling*. Then we show that Section 13(d) of the Securities Exchange Act (1934) supports interpretation of mandate ownership. Finally, we take mandate ownership beyond Section 13 and link it to the element underlying the franchise of corporate voting, thereby showing its significance to corporate control. We conclude with some observations and open questions.

## II. A CONTRACTUAL VIEW OF THE CORPORATE SHARE

Financial instruments are often seen as traditional “assets.” Traditional “assets” are governed by property law, where ownership is defined only in certain acceptable, albeit limited, ways.<sup>5</sup> Under such view, the owner of a corporate share is the person who invested the money to purchase the security: the “purchaser.” The “purchaser” holds a right to the share, and this right is inherent in the asset. However, a financial asset, unlike a real asset, is intrinsically a contract: a contractual promise.<sup>6</sup> As contracts, financial assets are governed by a different set of rules. Under contract law, the parties to a contract may agree on almost any legal terms, and they can either grant or limit the transfer of contractual rights to third parties.<sup>7</sup> A contractual view of share ownership, therefore, does not consider the purchaser’s rights to be inherent in the asset. The relevant “owners” of the asset under this view, are not “purchaser” and “provider”; but “parties” with a mandate that empowers them to exercise discretion over the asset’s (i.e. contract) decision-making. The contractual nature of financial assets makes possible the various decoupling techniques and derivatives-based separation of voting power from financial interests.<sup>8</sup> To reflect the

at 34-36 (2016); Elhauge, *Horizontal Shareholding*, 129 Harvard L. Rev. 1267 (2016); Posner, Scott Morton & Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, Antitrust Law Journal, Forthcoming. Available at SSRN: <https://ssrn.com/abstract=2872754> (March 22, 2017).

4 BlackRock, viewpoint on *Index Investing and Common Ownership Theories*, March 2017 (see: <https://www.blackrock.com/corporate/en-gb/literature/whitepaper/viewpoint-index-investing-and-common-ownership-theories-eng-march.pdf>)

5 Frankel, *The New Financial Assets: Separating Ownership from Control* 33 Seattle U. L. Rev. 931, 934 (2010).

6 Id.

7 Id.

8 On derivative-based decoupling: e.g. Hu & Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 South. Cal. L. Rev., 811 (2006); Hu & Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions* 156 U. of Penn. L. Rev. 625 (2008); Hu, *Financial Innovation and Governance Mechanisms: the Evolution of Decoupling and Transparency* 70 Business Lawyer 347 (2015).

contractual nature of the corporate share, and to contrast with the property nature of traditional views, we refer to two updated types of owners: those holding *entitlement ownership* (the traditional “purchaser,” or as sometimes referred to “end-investor”) and those holding a *mandate ownership* (or “record holders”).

### III. ASSET MANAGEMENT DECOUPLING

The decoupling of economic and control rights has not been restricted to derivatives. An expanding intermediary level of large asset managers has led to increasing divergence between the interests of so called “record holders” and those of “beneficial owners.”<sup>9</sup> The proxy system separates between intermediary record holders (the investment funds) and the holders of entitlement to economic benefits of a referenced share.<sup>10</sup> Entitlement holding, thus, reflects not a right to the securities, but a right to receive from the intermediary benefits in a proportion equal to what the holder would have received had they held the actual share.

A double contract structure is therefore introduced: the entitlement owners provide capital according to their contractual relationship with the institutional intermediary (governed by, for instance, an investment management agreement or prospectus), and thereby assume all the risk. The intermediary enters into a separate contractual relationship with the issuer (the share), retains complete authority over investment decisions, and gives back to entitlement owners *only* the economic benefits equal to their part in the referenced share. Ownership is consequently re-structured.

However, decoupling does not stop there. The major shift toward passively managed index funds in recent years and its subsequent concentration<sup>11</sup> has led to the creation of another step: the voting power that the funds as intermediaries traditionally retained is now being harnessed by the parent asset management firm, taking decision making further away from where the risk lies. The consequences are currently not fully known and, in any case, go beyond the scope of this article. Yet, share ownership, as we will next show, refers precisely to the type of share holding that intermediaries – and now, so unprecedentedly, the Big Three – have.

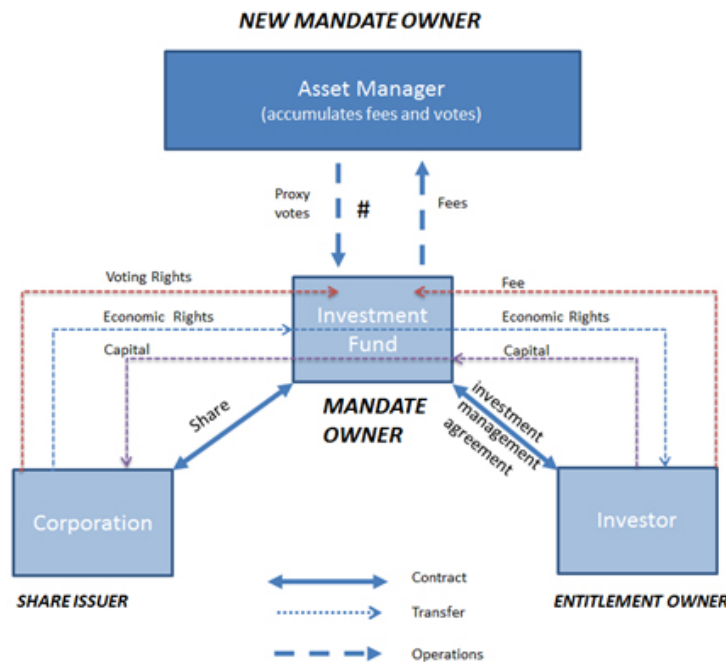


Figure 1: Asset Management Decoupling through Mandate Ownership

9 Gilson & Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights* 113 Columbia L. Rev. 863,889-896 (2013) (referring to institutional investors).

10 SEC Concept Release on the US Proxy System, July 2010, Release No. 34-62495, 11-21.

11 Fichtner *et al.*, *supra* note 2.

## IV. WHO IS THE OWNER? REREADING SECTION 13(D) THE SECURITIES EXCHANGE ACT (1934)

SEC Rule 13d-3 sets a dual test for “beneficial ownership” of equity securities. It identifies beneficial ownership as the possession of *either* the power to vote (or to direct voting) *or* the power to dispose (or direct the disposition) of securities, *or both*.<sup>12</sup> Under this test at least one condition is required for ownership determination, but any of the two satisfies the requirement. The possibility of sharing the power means that more than one person can beneficially own a share. A person can therefore acquire beneficial ownership in equity securities without having any property right to residual value.

Yet Section 13(d) and its applicable rules do not only support an interpretation of mandate ownership. They place the ability to exercise *de facto* power above any formal legal title to the share, and make it in fact superior to any other type of ownership. The SEC has formally recognized the supremacy of the *ability to exercise de facto power over any formal title to the share* as a constituent element of beneficial ownership, by explicitly indicating that “the mere possession of a legal right to vote is not determinative of who is the beneficial owner *inasmuch* as another person has the power, whether legal, economic or otherwise to direct such voting.”<sup>13</sup>

The supremacy of *de facto* power over legal title is clear from two additional elements of the Rules. First, the regulator extended “beneficial ownership” to include persons holding a right to own any time within 60 days, not only those who currently own, equity shares. The emphasis is on whether a person is legally entitled to relocate the power of the share (in this case, place it at their own disposal); i.e. to change (within 60 days) the identity of the person who may exercise the voting and/or investment power. Second, the exemption to record holders who may vote on some matters without instruction from the individual for whom they hold the stock, only exempts one class of record holders: those who can vote without instruction on matters “other than contested matters or matters that may affect substantially the rights or privileges of the holders of the securities to be voted.”<sup>14</sup> This exemption, in fact, supports the general rule. Except for the limited cases where the exemption applies, if one person holds the legal right to vote while another has the actual power to decide the voting, only the person able to direct the voting must disclose.<sup>15</sup>

The ability to exercise *de facto* power over decision making is the essence of mandate ownership. This implies that at least asset managers such as BlackRock, State Street and Vanguard are mandate owners through their funds. Recent research into the proxy voting of the funds within the Big Three shows extremely high levels of voting consistency, by studying proxy votes at Annual General Meetings where asset managers invest through at least two separate funds. At BlackRock, in only 18 per 100,000 proposals, one of their funds did not vote along with the other funds, and for Vanguard this is even more consistent with only 6 per 100,000 of the proposals receiving mixed votes.<sup>16</sup> The findings suggest that these asset managers coordinate proxy voting across their funds, which is in line with their recent efforts to set up and expand corporate governance departments at the group level. This observation leads to the conclusion that the Big Three have now acquired mandate ownership status at the group level, as it is precisely at this level where the *de facto* power over decision making rests.

This conclusion may not be disputed by the asset managers themselves in relation to reporting obligations (under either Section 13d or 13g); indeed the Big Three (and others) report their aggregated positions. The question we now ask is whether mandate ownership goes beyond “threshold reporting”? We propose that it does. Asset management decoupling, combined with voting power coordination, make the accumulated ability of the new mandate owners to exercise *de facto* power over corporate shares increasingly relevant for the market for corporate control: these positions seize and encapsulate the core element of the franchise of corporate voting.

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12 17 CFR § 240.13d-3.

13 Adoption Beneficial Ownership Disclosure Requirements, Exchange Act Release No. 13291, 42 Fed. Reg. 12342, 12344 (1977).

14 17 CFR § 240.13d-3(d)(2).

15 *Calvary Holdings Inc., et al. v. Burton Chandler*, 948 F.2d 59, 63 (1st Cir. 1991).

16 Fichtner et al., *supra* note 2, at 20.

## V. THRESHOLD REPORTING FOR CORPORATE CONTROL: EXTENDING MANDATE OWNERSHIP

### *A. Aggregated reporting of beneficial ownership ensures the accurate disclosure of the accumulated ability to exercise de facto power*

Two scenarios where the rules require aggregated-position reporting suggest that aggregation aims to expose otherwise hidden accumulations of mandate ownership. First, members of a group (as defined by the Rule) are required to file a statement and report their collective ownership.<sup>17</sup> By requiring groups to report information on their collective aggregated level of ownership, the regulator created a mechanism whereby persons conspiring to act in a concerted manner in relation to specific equity securities (and therefore holding market-sensitive relevant information) cannot hide behind the absence of formal written agreements<sup>18</sup> or the fact that they did not formally purchase additional shares.<sup>19</sup> The sufficient element to constitute such group-level aggregated reporting obligation, is that the persons are combined in furtherance of a common objective.<sup>20</sup>

Second, the SEC has recognized that certain organizational groups are comprised of parents and affiliated business units that operate independently of each other.<sup>21</sup> It then specifically noted the extent to which the affiliated units exercise voting and investment powers independently, as the main factor to determine the parent's reporting obligations.<sup>22</sup> In other words, only when the organizational structure confers mandate ownership on the parent, the shares of the affiliated units are counted toward the parent's reporting threshold. In all other cases, attribution is not required. Aggregation here, again, is designed only to expose accumulation of mandate ownership.

### *B. Disclosing the accumulated ability to exercise de facto power links mandate ownership to the market for corporate control*

The target beneficiaries of the disclosure regulatory scheme are the investors participating in the corporate control market. The requirement to aggregate all securities beneficially owned, regardless of the form which such beneficial ownership takes<sup>23</sup>, implies an instrumental - not arbitrary - nature to disclosure. The mechanism is designed to draw attention to otherwise hidden large accumulations, by ensuring the disclosure of all market-sensitive data about changes in the identity of those who are able, as a practical matter, to influence the use of the shares' power.<sup>24</sup> The requirement to aggregate mandate-ownership positions and the five percent threshold,<sup>25</sup> together confine reporting *only* to the type of information which is relevant to the decision making of other investors on issues involving corporate control.

The exemption from Schedule 13D filing given to Qualified Institutional Investors<sup>26</sup> ("QIIs") shows the instrumental nature of disclosure. While QIIs are still the beneficial owners of corporate shares, they presumably acquire securities in the ordinary course of their business and not with a control purpose or effect.<sup>27</sup> The market-sensitive information they hold,

<sup>17</sup> 17 CFR § 240.13d-5(b).

<sup>18</sup> *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982); *Hollywood Realty Partners, L.P. v. Gotham Partners, L.P., et al.*, 286 F.3d 613, 617 (2d Cir. 2002).

<sup>19</sup> *GAF Corp. v. Milstein*, 453 F.2d 709, 718 (2d Cir. 1971).

<sup>20</sup> *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982).

<sup>21</sup> *Amendments to Beneficial Ownership Reporting Requirements*, Exchange Act Release No. 39538, 63 Fed. Reg. 2854 (1977)

<sup>22</sup> *Id.*, at 2857.

<sup>23</sup> 17 CFR § 240.13d-3(c)

<sup>24</sup> *SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y. 1993) (citing 3 Securities Law Techniques § 70.07[2][c] (A.A. Sommer, Jr. ed., 1987)).

<sup>25</sup> 17 CFR § 240.13d-1

<sup>26</sup> 17 CFR § 240.13d-1(b)

<sup>27</sup> 17 CFR § 240.13d-1(b)(1)(i). The exemption allows greater margin in corporate governance activities than the passive investment exemption in antitrust regulation.

therefore, is considered less crucial for the market in the immediate term.<sup>28</sup> Nevertheless, the exemption depends on their practice (the manner in which they manage the investment), not their status. Where sufficient evidence suggests otherwise, the presumption is rebutted, making their ownership reportable on Schedule 13D.<sup>29</sup> This option of losing and re-establishing Schedule 13G eligibility only makes sense if “threshold reporting” is instrumental, not arbitrary.

### ***C. Aggregated mandate ownership positions capture the element of share holding that forms the basis for the franchise of corporate voting***

The orderly operation of the market for corporate control relies on legal tools to balance between independent decision-making of corporate management and the interests of shareholders. Shareholding in the context of corporate control, however, reflects only the elements of share ownership that make such owners the appropriate franchise for corporate voting. Shareholding as the basis for the franchise of corporate voting is founded on the assumption that shareholders are the most suitable constituents to trigger the corporate control mechanism, since the best signal for identifying board errors is the stock price.<sup>30</sup> Corporate voting, therefore, does not rely on shareholders; it relies on share-*mandate*-holders. The aggregated position of mandate owners (and “new mandate owners”) is thus not an arbitrary statutory threshold. It is a regulatory formula designed to expose where power over companies actually resides.

The power of shareholders voting is reflected, for example, in the practice of judicial review of boards’ fiduciary after *Corwin*.<sup>31</sup> While Delaware generally refers to the business judgment rule as the default standard of review; in situations where the realities of the decision making context can subtly undermine the decisions of even independent and disinterested directors,<sup>32</sup> applicants challenging the decision can rebut the presumption, showing the board was interested, not sufficiently informed or otherwise did not act in good faith.<sup>33</sup> After *Corwin*, however, a voting of un-coerced, fully informed, and disinterested holders of a majority of the shareholders, seems to significantly limit the available means for challengers of a board’s decision; leaving them with only very few, if any, options to successfully plead due care liability.<sup>34</sup> The power of shareholders voting to determine the judicial standard of review in change-of-control transactions is only one example showing that in fact mandate owners, as the franchise of corporate voting, are the only constituent to which corporate managers are accountable.

## **IV. CONCLUSIONS**

The Big Three are the new mandate owners to the extent that they coordinate the otherwise independent decision making of their different funds. Evidence from our previous research suggests they do.<sup>35</sup> Their power as mandate owners exists irrelevant of any entitlement positions. They are, as we argue, the relevant owners when it comes to issues of corporate control as they hold the *de facto* power over decision making. This power is derived from the sizable portions of mandate ownership they have accumulated and the influence this gives them over corporate decision making. While they may indeed be passive investors and will not “exit” underperforming firms by selling their shares, they are not passive owners. There is no doubt they exert considerable and increasing influence over much of Corporate America.<sup>36</sup>

28 17 CFR § 240.13d-1(b)(2). The reporting schedules and required information are thus different than those of other non-passive beneficial owners. While the presumption may be debatable in light of various statements made recently by large institutional investors; the full debate is beyond the scope of this present article.

29 17 CFR § 240.13d-1(e).

30 Thompson & Edelman, *Corporate Voting*, 62 Vanderbilt L. Rev. 129, 149 (2009).

31 *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 305 (Del. 2015).

32 *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

33 *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 180 (1986); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955, 957 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

34 *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 305, 312 (Del. 2015).

35 Fichtner et al., *supra* note 2.

36 Fichtner, Heemskerk & Garcia-Bernardo, *These three firms own corporate America*, The Conversation. Available at: <https://theconversation.com/these-three-firms-own-corporate-america-77072> (May 10, 2017).

We like to point out that this power exists irrelevant of any empirical evidence on anticompetitive effects. Leaving aside questions of effects on price levels or formal definitions of ownership and passivity in antitrust regulation; there can be little doubt that mandate owners hold precisely the kind of power that makes a difference for corporate business strategies, including competition-policy decisions. Mandate ownership positions capture the core element of shareholding which matters most to corporate management: the power to vote. Referring back to our proposed model (Figure 1), when corporate managers make business decisions, their outlook is confined only to their contractual relationship with mandate owners. They need not look any further. As far as they may be concerned, accountability ends with the one who casts the vote.

BlackRock noted that “[e]ngagement via voting is a means for long-term investors, whose money is managed by asset managers as fiduciaries, to have a voice in corporate governance.”<sup>37</sup> Our proposition does not dispute this claim. We simply note that exercising *de facto* power over proxy voting of multiple funds constitutes mandate ownership. Fiduciary duties do not invalidate acquisition of mandate ownership. Rather, fiduciary obligations are part of the (separate) contractual relationship between the mandate, and entitlement, owners.

The question of Fiduciary responsibility, however, does raise an important issue. The new mandate owners are burdened with a nigh impossible task: they must reconcile an overwhelming amount of conflicting Fiduciary duties and conflicts of interest. The success of their business model of passive investment has now put them center stage in corporate governance as new, very large, mandate owners. From our perspective, this leading position comes with responsibilities. Already the asset managers are keen to increase their transparency on voting and engagement practices. Given their pivotal new power position in corporate decision- making we expect further steps to be taken towards even more transparency and also towards predictability. The Big Three can move beyond general principles or policy statements and make specific commitments with enforceable accountability mechanisms. Such adaptations, however, necessarily come at a cost. From a business perspective, the fear of losing clients and of rising costs may deter such policy changes. Moreover, enforcement of more specific voting guidelines would almost inevitably bring to the fore the enormous (yet still latent) influence of the three largest new mandate owners: BlackRock, Vanguard, and State Street. For now, at least, the question remains open: are the new mandate owners in fact willing, or even able, to carry such a burden?

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<sup>37</sup> BlackRock, *supra* note 4, at 12.

